““# IDAHO OUTLOOK

NEWS OF IDAHO’S ECONOMY AND BUDGET

STATE OF IDAHO **DIVISION OF FINANCIAL MANAGEMENT** **NOVEMBER 2002 VOLUME XXIV NO. 05**

Deflation is decreasing prices over time. For those of us who began our formal study of economics during the Carter Administration and the Volcker Fed, it is not a topic with which we are very familiar. Two decades or so ago, we were consumed with the misbehavior of inflation, and with good reason. During the period that some economists refer to as “the great inflation,” the economic problem de jour was rapidly rising prices. From 1966 to 1996 consumer prices rose 5.4% annually, compared to 1.8% per year in the 15 years from 1950 to 1965. This played havoc for business planners and required some strong medicine from the Federal Reserve to fix.

If deflation is the opposite of inflation, and inflation is undesirable, does that make deflation desirable? The short answer is “depends.” While consumers may benefit from falling prices, it is important to determine why they are falling. Increased productivity causes prices to fall, which is desirable. Productivity increases when the amount of output per unit of labor increases. Because of these efficiencies, businesses’ bottom lines improve. Some of these gains will be reinvested by the company providing the capital for further economic growth. Some will be passed to employees in the form of higher pay, which improves their standards of living.

But deflation is often a symptom of imbalances in the economy. For example, current deflationary pressures are the result of excess global production combined with soft demand due to the world recession. Recently, supply has outpaced demand, and this caused the technology bubble to burst and equity markets to collapse. The decline in investment needs and loss of stock market wealth are the key sources of spending weakness. This slump in demand, combined with abundant supply, has suppressed prices increases. History provides an example of why falling prices are not necessarily desirable. America’s longest period of deflation occurred during its worst economic downturn: the Great Depression. From 1929 to 1935 prices fell a total of 20%. This decline was primarily due to the lack of final demand that also sent real GDP backpedaling.

Nearly 75 years after the start of the Great Depression, some economists are once again concerned about deflation. (However, no one expects anything near a repeat of the greatest U.S. economic calamity.) Evidence supporting this point of view is the significant slowdown in inflation over the last few years. Since the early 1990s, inflation has been three percent or less per year. (It was 3.4% in 2000, but this was due to temporary spikes in energy prices.) Another reason economists are concerned is because there is a general agreement that the government estimates overstate inflation. That is, actual inflation is lower than the official estimates by 1 to 2 percent. Thus, if we subtract this from the official estimate we find actual inflation is indeed near zero. Thus, we are closer to deflation than the official estimates. Given where we are, it is a good idea to review two impacts of deflation.

Deflation hurts debtors. This is a serious concern given the soaring levels of debt in recent years. A business or individual who took on debt expecting sales or income gains of 5% may face trouble if gains slowed or fell. As a result, businesses may suppress their hiring and investing. Consumers may retrench. It could also restrict the supply of credit, as lenders grow wary of increasing bankruptcies. Debt levels for U.S. households and businesses are at record levels, but low nominal interest rates are keeping debt service manageable. However, the key stress would be a further rise in real interest rates (nominal rates less the inflation rate). This could happen with unchanged nominal interest rates and price deflation. For example, if the short-term interest is at 1.25% and prices remain flat, then the real interest rate is 1.25% (1.25%-0%). However, it prices fall 1% then the real interest rate climbs to 2.25% (1.25%-(-1.0%)). It could also happen if nominal interest rates rise faster than inflation. In either case, real interest rates would rise, stressing debtors who would be paying with relatively more expensive dollars.

Deflation limits policy options. To see this, assume the Federal Reserve lowers its nominal federal funds rate to 0%, the lowest it can go. Also assume prices fall 2 percent. This implies a real interest rate of 2% (0-(-2)). Since the central bank cannot lower the target federal funds rate below zero percent, falling prices would raise real interest rates. This loss of “traction” by the central bank would come when it was most needed. This is one of the problems facing Japanese policy makers. Its short-term interest rate is virtually zero, but the economy remains in the doldrums because deflation is boosting real interest rates. It is now widely accepted that a small amount of overall inflation is necessary to make a positive impact to economic stability. Otherwise, the Federal Reserve cannot move actual rates well below inflation, which prevents the central bank from producing negative real interest rates.

In the late 1970s, comedian Dan Aykroyd gave a satirical speech on the TV show *Saturday Night Live* called, “Inflation is Our Friend.” Spoofing then-president Jimmy Carter, the comedian extolled the virtues of runaway inflation. One benefit: “Just think how impressed your neighbors will be when you drive up in your new quarter million dollar car.” Of course, he was making light of a serious situation. Runaway inflation is not our friend, and neither is deflation.

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General Fund Update

As of October 31, 2002

Revenue Source	FY03 Executive Estimate[3] ($ Millions)	DFM Predicted to Date ($ Millions)	Actual Accrued to Date ($ Millions)
Individual Income tax	890.9	256.7	259.6
Corporate Income tax	81.8	23.4	30.8
Sales Tax	673.2	236.6	246.8
Product Taxes[1]	21.6	7.6	7.6
Miscellaneous	99.9	25.4	26.5
TOTAL GENERAL FUND[2]	**1,767.4**	**549.7**	**571.3**

1 Product Taxes include beer, wine, liquor, tobacco and cigarette taxes
2 May not total due to rounding
3 Revised Estimate as of August 2002

General Fund revenue was only slightly ($0.6 million) ahead of target in October, breaking a trend that had developed over the first three months of fiscal year 2003. However, the fact remains that the General Fund is $21.6 million higher than expected on a year- to-date basis, thereby providing a comfortable cushion as we go into the highly-anticipated Christmas shopping season.

Individual income tax revenue was $0.6 million higher than expected in October, bringing year-to-date collections $2.9 million above expectations. Withholding collections were $1.0 million lower than expected in October, and are now $0.8 million lower than expected on a year-to-date basis. Filing payments were $1.9 million higher than expected in October, and are $5.3 million higher than expected for the fiscal year to date. Refund payouts were $0.3 million higher than expected in October and are $3.0 million higher than expected for the year to date.

Corporate income tax revenue was $0.1 million higher than expected in October, and now stands $7.4 million ahead of the year-to-date predicted amount. For the month filing payments were $1.1 million higher than expected, quarterly estimated payments were $0.7 million lower than expected, and refunds were $0.3 million higher than expected. On a year-to-date basis the strongest component is filing payments, which are $6.8 million higher than expected. Quarterly estimated payments are a more modest $1.9 million ahead of expectations. Refunds are $1.1 million higher than expected for the fiscal year- to-date. Year-to-date filing payments are exceptionally strong this year. Since FY 1987, only one prior year (FY 1997) has had higher filing payments in the first four months of the fiscal year.

Sales tax revenue was $0.8 million lower than expected in October, making it the first month of substandard sales tax performance this fiscal year. This revenue category is still $10.2 million higher than predicted for the fiscal year to date, and still accounts for almost half of the current General Fund excess. Exceptionally strong motor vehicle sales in Idaho accounted for much of the strength in the first three months, and October's year-over-year decline in auto sales tax (the first since March of 2001) is very likely the main driver behind this month's weakness.

Product tax revenue was $0.1 million higher than expected in October. Miscellaneous revenues were ahead by $0.6 million, with most of the strength in interest earnings.